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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1049

ST. LOUIS UNION TRUST COMPANY, a Corporation, KENNETH H. BITTING, JR., WILLIAM C. BITTING and GEORGE C. BITTING, as Executors of the Last Will of Kenneth H. Bitting, Deceased,

Petitioners,

against

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., a Corporation, DONALD T. REGAN, NED B. BALL and GEORGE L. SHINN,

Respondents.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

RESPONDENTS' BRIEF IN OPPOSITION TO THE PETITION FOR A WRIT OF CERTIORARI

WILLIAM P. ROGERS
STANLEY GODOFSKY
JAMES N. BENEDICT
200 Park Avenue
New York, New York 10017
(212) 972-7000

Of Counsel:
ROGERS & WELLS

JAMES B. MAY
ROGER J. HAWKE
One Liberty Plaza
New York, New York 10006
(212) 349-7500

BROWN, WOOD, IVEY,
MITCHELL & PETTY

JOHN J. COLE
611 Olive Street
St. Louis, Missouri 63101
(314) 621-5070

ARMSTRONG, TEASDALE,
KRAMER & VAUGHAN

ERNEST L. FOLK, III
University of Virginia
School of Law
Charlottesville, Virginia 22901
(804) 924-3022

Attorneys for Respondents

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Question Presented

Does the routine exercise, for valid corporate purposes, of an option to repurchase stock, which was authorized by Delaware law, required to be included in the charter of the corporation by the Rules of the New York Stock Exchange, and specifically assented to by the stockholder prior to his acquisition of the stock, constitute a violation of either Section 10(b) of the Securities Exchange Act of 1934 or applicable state law?

Statement of the Case

Material Facts

Petitioners' statement of the case is based upon a version of the facts which was rejected by the Eighth Circuit as clearly erroneous.[1] Petitioners' claim that there was a "clearly proven scheme of deception, non-disclosure, self-aggrandizement and unfairness" (Petition at 8), upon which their legal arguments are predicated, ignores the fundamental holding of the Court of Appeals that there was no scheme, no deception, no fraud, no unfairness, and no breach of fiduciary duty.

In fact, this case simply involves the routine exercise by a closely-held corporation of a long-standing option to repurchase its stock upon the death of one of its stockholders.

Petitioners are the executors of the Estate of Kenneth H. Bitting ("Bitting"). Respondents are Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch" or "the Corporation") and three individuals—Donald T. Regan, George L. Shinn and Ned B. Ball—who were senior executives and members of its Board of Directors in 1970.

Prior to 1958, Merrill Lynch was a limited partnership, of which Bitting was a general partner. In 1958, the Corporation was organized under the laws of Delaware and succeeded to the business and assets of the partnership. Thereafter, until June 1971 when Merrill Lynch went public, it was a closely held corporation, substantially owned and controlled by those who, if the Corporation had remained in partnership form, would have been the partners in the firm.

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[1] The Eighth Circuit's opinion is reported at 562 F.2d 1040 and is reprinted in Appendix C to the Petition, pages A-33 through A-64. References herein to the Court of Appeals' decision are cited to both the official reporter and the Appendix to the Petition.

Upon the organization of the Corporation, Bitting, whose partnership capital was valued at $240,000, received 9,100 shares of the Corporation's voting stock and a $58,000 debenture in exchange for his partnership interest. As a result of a 3-for-1 stock split, Bitting became the owner of 27,300 shares of Merrill Lynch voting stock.

Under Merrill Lynch's original Certificate of Incorporation, all common stock, including that issued to Bitting, was restricted against transfer and subject to the Corporation's option to repurchase as specifically authorized by the Delaware General Corporation Law. Bitting, as a general partner, had reviewed a draft of the original Certificate of Incorporation and had specifically assented to its terms. These included Merrill Lynch's option to purchase a holder's stock at its net book value upon the occurrence of several specified contingencies, including the death of a stockholder.[2] The transfer restrictions, including the Corporation's repurchase option, were conspicuously noted on each stock certificate.

Upon his retirement in December 1962, Bitting exchanged his 27,300 shares of voting stock for over $400,000 in cash and 10,000 shares of non-voting stock.[3] As a result of two additional stock splits between 1962 and 1970, Bitting became the owner of 40,000 shares of non-voting stock.

Bitting died on October 8, 1970. Pursuant to the terms of its Charter, Merrill Lynch exercised its option to repurchase the 40,000 shares of stock on November 18, 1970.[4]

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[2] Each stockholder also had the right to "put" his stock to Merrill Lynch at any time at its net book value.

[3] Only persons active in the business were permitted to own voting stock.

[4] As the Court of Appeals noted, the exercise of the option followed automatically and uniformly upon the death of each stockholder since Merrill Lynch's incorporation in 1958. (562 F.2d at 1049-50, n.14; A-47, n.14). The Court found the option was "consistently exercised by the company and supported by lawful business purposes." (562 F.2d at 1055, n.23; A-58, n.23).

Thereafter, the Corporation offered Bitting's widow an opportunity to acquire 10,000 shares of non-voting stock, which she accepted. In each instance the purchase price of the stock was $26.597 per share, its net book value as of October 30, 1970. The Bitting Estate realized a profit of approximately $1,000,000 on the sale of its 40,000 shares to Merrill Lynch.

Although Merrill Lynch was a privately held company until 1971, it had long advocated public ownership of brokerage firms, and its position was a matter of widespread public knowledge. In February 1970, shortly after the New York Stock Exchange ("Exchange") indicated that it intended to amend its rules to permit public ownership of member firms, the Corporation appointed a committee to consider public ownership for Merrill Lynch. That Merrill Lynch was engaged in the spring of 1970 in planning for eventual public ownership was not a closely guarded secret; in fact, it was widely known and reported in such publications as *Business Week* and *The New York Times.*

After six months of internal study, the Corporation's Board of Directors resolved on July 14, 1970 to create a task force to conduct an accounting and legal audit of the Corporation's business and structure to acquire the capability of going public by the spring of 1971.[5]

The evidence establishes, however, that no decision was made on July 14, 1970 to go public in the spring of 1971. Everyone knew that substantial hurdles would have to be overcome if the corporate aspiration for public ownership were ever to be realized. The securities industry was in a

[5] Contrary to petitioners' suggestion (Petition at 6, n.5), this fact was known to both James E. Thomson and Darwin Fenner, both of whom participated in the Board's deliberations and voted in favor of the resolution.

shambles,[6] Merrill Lynch's earnings were severely depressed, the Dow Jones Industrial Average was at one of its lowest points in almost a decade, and the National Association of Securities Dealers ("NASD") was adamantly opposed to a member participating in the distribution of its own securities to the public.[7]

Despite these obstacles, the task force, pursuant to the Board resolution, began its work in July 1970 to develop a capacity for Merrill Lynch to go public when and if circumstances permitted. Tentative time schedules and target dates were fixed, auditors were engaged to prepare appropriate financial statements, lawyers were retained to prepare a draft prospectus, and the task force met from time to time to consider such matters as the size of any proposed offering, the advisability of stock splits and other matters.

Conditions in the securities industry remained dismal throughout 1970. Moreover, the impediments to a public offering known in July were immensely compounded in November 1970 when Merrill Lynch acceded to the Exchange's urgent request to take over Goodbody & Co., the fifth largest brokerage firm in the country, and thereby rescue it from the brink of bankruptcy.

Unpredictably, late in the first quarter of 1971 a series of fortuitous occurrences encouraged Merrill Lynch's management to believe that a public offering would be possible in the reasonably foreseeable future. The nation's economy picked up dramatically, the Dow Jones Industrial

[6] *See Securities Investor Protection Corp.* v. *Barbour,* 421 U.S. 412; 116 Cong. Rec. 40868 (1970) (remarks of Senator Muskie).

[7] Merrill Lynch believed that a public offering would not have been possible unless the NASD changed or modified this policy because the Corporation would otherwise not have been able to offer its stock to its own customers without turning over to its competitors its extremely valuable and confidential customer lists.

Average "went up almost vertically," Merrill Lynch's earnings improved significantly, and the magnitude of the liabilities assumed in the Goodbody rescue, previously estimated at between $30,000,000 and $50,000,000, were determined to be less than $4,500,000 in excess of the Exchange's $20,000,000 indemnity to Merrill Lynch.

In March 1971, the individual respondents concluded that a public offering then appeared feasible if certain remaining uncertainties, particularly the NASD policy against self-underwriting, could be resolved. After receiving indications that the NASD and the staff of the SEC both favored a modification of the NASD policy, a proposal for public ownership was presented to and approved by the Board at its April 8, 1971 meeting and the stockholders voted their approval at their annual meeting on April 20, 1971.

On April 23, 1971, Merrill Lynch filed a registration statement with the SEC and on June 23, 1971, following a three-for-one stock split, 4,000,000 shares of the Corporation's stock were offered to the public at a price of $28 per share.

The Court of Appeals' Opinion

Petitioners argued below that the respondents arrived at a secret decision on July 14, 1970 to go public, which they concealed from the entire Board of Directors in an effort to fraudulently increase the public offering price and to maintain their control of management after the public offering. The option was supposedly exercised in furtherance of this "scheme".

The Court of Appeals clearly acknowledged, understood and rejected petitioners' contentions. (562 F.2d at 1044; A-36). It specifically held, after a careful review of the 2,800-page Joint Appendix, that there was "no fraud" or "supervening bad faith" or "improper motive" on the part of the respondents. (562 F.2d at 1044-45, n.7, 1053; A-37, n.7, A-54). It stated that it had

> "reached the conclusion that there was *no fraud* on the part of the defendants prior to November 18, 1970, at least as such alleged fraud may have applied to Bitting. To the extent that the district court held to the contrary, we consider his factual findings to be *clearly erroneous*." (562 F.2d at 1044-45, n.7; A-37, n.7). (Emphasis added)

In the face of such findings it is incomprehensible how petitioners can persist in asserting that the Court of Appeals did not set aside any of the District Court's findings of fact concerning the allegedly fraudulent scheme.

The Court of Appeals also held that Merrill Lynch's option to repurchase its stock upon the death of a stockholder was valid *per se* under § 202(c)(1) of the Delaware General Corporation Law (562 F.2d at 1045; A-37), and that the exercise of the option did not constitute a violation of Rule 10b-5. The Court reasoned that inasmuch as petitioners' knowledge or ignorance of a future public offering was wholly irrelevant to their obligation to sell the stock, the alleged failure to disclose such information was not material as a matter of law (562 F.2d at 1049-50; A-46-47).[8] No judge in the Court below—not even Judge Heaney in dissent—found a violation of Rule 10b-5.

The Court of Appeals further found that the option was "consistently exercised by the company and supported by lawful business purposes." (562 F.2d at 1055, n.23; A-58, n.23). Thus, the Court of Appeals held:

> "[W]e note that the transfer restriction was justified by a number of lawful and reasonable business purposes. Rule 313.21 of the New York Stock Exchange, of which Merrill Lynch was a member, *required* the company to repurchase the shares of any stockholder who died, so long as the stock was not freely transferable. It is true that on March 26, 1970, the Exchange

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[8] It should be noted, in any event, that the majority rejected the claim that Bitting's executors were unaware of Merrill Lynch's plans for eventual public ownership. (562 F.2d at 1049, n.13; A-46-47, n.13).

amended its rules to permit member firms to hold freely transferable securities. However, Rule 313.21 continued to apply to Merrill Lynch until the company had freely transferable stock outstanding. This occurred on June 23, 1971, the date of the public offering, *after* the Bitting stock was purchased. Additionally, in 1959, the company obtained an exemption from the registration requirements of the Securities Act of 1933 on the representation to the SEC, *inter alia,* that the Exchange required the company to have an option to purchase the shares on the happening of certain contingencies. In 1967, Merrill Lynch obtained an exemption from the registration and reporting requirements of § 12(g) of the Securities Exchange Act of 1934 on the basis of its representation that it would remain a privately held company by enforcing its stock restrictions. At the time the Bitting stock was purchased, the company could have reasonably believed that the removal of the stock restrictions would have created a public market for the company's stock and, in view of the unavailability of the registration materials, resulted in a violation of the securities laws. Finally, the corporation had a legitimate interest in limiting stock ownership to those persons active in the business." (562 F.2d at 1053, n.17; A-53-54, n.17). (Emphasis in original)

In the light of these lawful and substantial business purposes, the Court of Appeals concluded that the Corporation's option had been exercised in good faith and that respondents had not breached any fiduciary duty to petitioners. (562 F.2d at 1055, n.23; A-58, n.23).

Following the decision by the Eighth Circuit on August 26, 1977, petitioners sought a rehearing *en banc.* Of the seven judges of the Court of Appeals who considered the petition, only one, the original dissenter, voted to permit a rehearing. (A-66).

Argument

The Petition does not raise any issues which warrant review by this Court. The Court of Appeals' decision is not in conflict with the decisions of this Court or those of any other circuit, and is in complete accord with applicable Delaware law.

POINT I

This Case Involves a Proper Application of the Decisions of This Court and of Well Established Legal Principles Under the Federal Securities Laws

The decision below represents no more than an application of well settled legal principles. As the Court of Appeals properly held, Merrill Lynch's option to repurchase Bitting's stock was legally enforceable and was exercised in good faith for valid corporate purposes. The Court thus held that no claim would exist under the federal securities laws, even if petitioners' claims of non-disclosure had been well founded.

The leading case of *Ryan* v. *J. Walter Thompson Co.,* 453 F.2d 444 (2d Cir. 1971), *cert. denied,* 406 U.S. 907, is squarely in point. It holds that no claim exists under the federal securities laws for failing to disclose a private corporation's plans for public ownership upon the exercise of its option to repurchase a stockholder's shares.

> "With respect to the Rule 10b-5 claim, the District Court held that, *since Ryan was obligated to sell his shares to JWT in January 1969, whatever he knew or did not know regarding JWT's plans to go public was irrelevant.* We agree. See Fershtman v. Schectman, 450 F.2d 1357, 1360 (2 Cir. 1971). Ryan's reliance upon SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2 Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969), is misplaced. Even under the broadest interpretation

of the language of *Texas Gulf Sulphur,* Rule 10b-5 does not spread a comfortable canopy to keep Ryan out of the inclement weather." *Id.* at 447. (Emphasis added)

Ryan has been followed consistently by virtually every court that has considered the question. *E.g., Ketchum* v. *Green,* 415 F. Supp. 1365 (W.D. Pa. 1976), *aff'd,* 557 F.2d 1022 (3d Cir. 1977), *cert. denied,* 46 U.S.L.W. 3306 (Nov. 7, 1977); *Keating* v. *BBDO International, Inc.,* 438 F. Supp. 676 (S.D.N.Y. 1977); *Weissman* v. *Smoler Brothers, Inc.,* [1976-77 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,878 (S.D.N.Y. Feb. 22, 1977); *Bank* v. *Fleisher,* 419 F. Supp. 1243 (D. Neb. 1976); *Blackett* v. *Clinton E. Frank, Inc.,* 379 F. Supp. 941 (N.D. Ill. 1974).

Applying these familiar principles, the Eighth Circuit correctly held:

"Any information concerning the public offering was not 'material' in the sense that a reasonable or objective investor, in the plaintiffs' circumstances, would likely have considered it important in making his decision to sell. Likewise, in reliance terms, any information concerning the public offering could not have subjectively influenced the plaintiffs to act differently than they did in selling the shares to the corporation pursuant to the terms of the stock restriction. The defendants were thus under no obligation—and had no federal 'duty' under § 10(b) and Rule 10b-5—to disclose any information to the plaintiffs concerning the public offering when the stock restriction was enforced.[15]

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"[15] The plaintiffs have not suggested how they might have acted differently had they been given prior notice of any company preparations to go public, aside from the observation that they would have taken every possible legal action to protect their interests. However, plaintiffs could have litigated nothing more at that time than they have litigated in this case. The point we wish to emphasize is that plaintiffs could have done nothing to block the sale of the stock. *Cf. Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, 474 n. 14, 97 S. Ct. 1292, 51 L. Ed. 2d 480 (1977)." (562 F.2d at 1049-50; A-47-48).

The Eighth Circuit's decision is wholly consistent with recent decisions by this Court. In *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, this Court held that only "material" nondisclosures or misrepresentations are actionable under Rule 10b-5, and that a fact cannot be considered "material" if the stockholder has no freedom of choice concerning the transaction. The Court concluded that failure to give advance notice of the merger there involved "was not a material nondisclosure within the meaning of the statute or the Rule" (430 U.S. at 474, n.14), and voiced in footnote 14 a thought that is equally applicable here:

"[R]espondents do not indicate how they might have acted differently had they had prior notice of the merger." *Id.*

Similarly, in *TSC Industries, Inc.* v. *Northway, Inc.,* 426 U.S. 438, 449, this Court said that "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding [whether or not to sell]." Where, however, a shareholder is contractually bound to sell, irrespective of information conveyed to him, that information cannot be said to be material. *See* R. Jennings & H. Marsh, *Securities Regulation,* 954 n. 41 (4th ed. 1977).

The Petition does not present any novel or important question for this Court's consideration and should be denied.

POINT II

There Is No Conflict Among the Circuits

Contrary to petitioners' claim, the Eighth Circuit's decision does not conflict with the holdings of the courts of appeals in *Ayres* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532 (3d Cir. 1976), *cert. denied*, 429 U.S. 1010; *Drachman* v. *Harvey*, 453 F.2d 722 (2d Cir. 1972) (*en banc*); *Schoenbaum* v. *Firstbook*, 405 F.2d 215 (2d Cir. 1968) (*en banc*), *cert. denied*, 395 U.S. 906; *Coffee* v. *Permian Corp.*, 474 F.2d 1040 (5th Cir. 1973), *cert. denied*, 412 U.S. 920; or *Bailey* v. *Meister Brau, Inc.*, 535 F.2d 982 (7th Cir. 1976).

Ayres arose on a motion to confirm an Exchange arbitration award in Merrill Lynch's favor. In *Ayres* a former employee's stock was repurchased by the Corporation upon his voluntary retirement. A majority of the Court of Appeals—relying extensively upon the findings and conclusions of the District Court in this case which were subsequently rejected by the Eighth Circuit—suggested that the alleged nondisclosure of the Corporation's plans for eventual public ownership might be material under the facts of that case. The Court noted plaintiff's allegation that if he had known of such plans he might have elected not to retire, and thus would not have triggered the exercise of the Corporation's option. Accordingly, the majority concluded that Ayres' complaint could be construed as one raising a claim under the federal securities laws and therefore not subject to mandatory arbitration. The District Court's confirmation of the arbitrators' award was therefore vacated and the case remanded for trial. The majority opinion below specifically considered the Third Circuit's decision in *Ayres*, and held that it was clearly distinguishable. (562 F.2d at 1053-54; A-55).

Petitioners' claim that the decision below conflicts with the decisions by the courts of appeals in *Drachman, Schoenbaum, Coffee,* and *Bailey* is simply wrong. In each of those cases deception was an integral part of the fiduciary misconduct which was held to violate Rule 10b-5 and each involved a situation where the defendants had initiated certain action without any justifiable corporate purpose. Here, however, the Court of Appeals expressly held that the option was exercised in good faith for lawful business purposes, and that there was "no fraud." (562 F.2d at 1044-45, n.7, 1053, 1055, n.23; A-37, n.7, A-54, A-58, n.23). The Court of Appeals cited, considered and specifically distinguished each of the cases relied upon by petitioners:

> "[W]hatever fiduciary duty of fair dealing the defendants might have owed to the plaintiffs in November 1970 was not breached by the enforcement of the stock restriction. *The sale was triggered by* Kenneth Bitting's *death* and the corporation's legal entitlement to call the plaintiffs' shares on the happening of that contingency, not by any supervening bad faith on the part of the defendants. *In each of the cases cited by the plaintiffs, an improper motive of the control group or a responsible person caused the corporation or the affected shareholder to suffer a loss in a transaction it would not otherwise have undertaken. This causation element is not present in this case.*" (562 F.2d at 1053; A-54). (Emphasis added)

There is thus no conflict between the Eighth Circuit's holding and the decisions of the courts of appeals relied on by petitioners.

POINT III

The Court of Appeals Properly Applied Delaware Law

The Eighth Circuit's opinion convincingly demonstrates that it was fully familiar with the applicable Delaware authorities and properly applied them to the facts of this case. Thus, the Court accepted the proposition, urged by

petitioners, that Delaware law superimposes a duty of good faith on every contract arising in a corporate framework, and that even valid corporate machinery cannot be used for an improper motive to injure minority stockholders. (562 F.2d at 1055, n.23; A-58, n.23). Indeed, it referred to those principles as "familiar" and cited a number of the very cases now relied upon by petitioners.[9] (*Id.*). It held, however, that the facts of this case did not warrant the application of those principles. (*Id.*).

Petitioners' claim under Delaware law is bottomed on the erroneous contention that the option to repurchase Bitting's stock was improperly exercised in furtherance of a fraudulent scheme. But the Court below held the option was not exercised for the purpose of defrauding anyone and was supported by a wide variety of lawful and valid corporate purposes. (562 F.2d at 1053, n.17; A-53-54, n.17). In such circumstances, the majority was clearly correct in declining to invoke the inapplicable principle of the Delaware authorities upon which petitioners rely. As the majority below stated:

> "None of the cases [cited by petitioners] even remotely impugns the company's right to exercise a repurchase option which was specifically assented to by the stockholder, consistently exercised by the company and supported by lawful business purposes." (562 F.2d at 1055, n23; A-58, n.23).

Petitioners seek nothing more than to have this Court review a decision by a panel of the Court of Appeals which was fully familiar with and properly applied the law of Delaware. Their Petition should, accordingly, be denied.

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[9] *Singer* v. *Magnavox Co.*, 380 A.2d 969 (Del. 1977), the only decision not cited by the Court below (but which was considered by it on petitioners' request for a rehearing), merely reaffirms the principle of the long line of Delaware authorities on which petitioners had previously relied.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the Petition for a Writ of Certiorari should be denied.

Dated: New York, New York
February 16, 1978

Respectfully submitted,

WILLIAM P. ROGERS
STANLEY GODOFSKY
JAMES N. BENEDICT
200 Park Avenue
New York, New York 10017
(212) 972-7000

Of Counsel:
ROGERS & WELLS

JAMES B. MAY
ROGER J. HAWKE
One Liberty Plaza
New York, New York 10006
(212) 349-7500

BROWN, WOOD, IVEY,
MITCHELL & PETTY

JOHN J. COLE
611 Olive Street
St. Louis, Missouri 63101
(314) 621-5070

ARMSTRONG, TEASDALE,
KRAMER & VAUGHAN

ERNEST L. FOLK, III
University of Virginia
School of Law
Charlottesville, Virginia 22901
(804) 924-3022
Attorneys for Respondents